22047 and 22047-A (Consolidated)

UNITED STATES COURT of APPEALS

FOR THE NINTH CIRCUIT

MELVIN L. HAIR and ESTHER HAIR, his wife,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

AND

RICHARD E. HAIR and NAOMI L. HAIR, his wife,
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vs.

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On Petitions For Review of Decisions of
The Tax Court of the United States
(Tax Court Nos. 3297-65 and 5001-65)

REPLY BRIEF OF PETITIONERS

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REPLY BRIEF OF PETITIONERS

Correction of Error

Nota Bene—An inaccuracy at page 37 of Petitioners' Opening Brief. The quotation there is not from **Wood v. United States** but from **Crowell Land & Mineral Corporation v. Commissioner,** 242 F (2d) 864, at 866 appearing in a footnote (24) in **Wood v. United States,** 377 F (2d) 300 at page 311. Regretfully, when proof was read on the Brief we failed to catch this error, discovered while writing this Reply Brief. The Clerk of this Court and opposing counsel have been notified of this unfortunate mistake.

RESTATEMENT OF THE CASE

The total circumstances, including objective tests of the intentions of the contracting parties as evidenced by the contract of "sale" and "purchase," Exhibit 6F (R. 84-87), should govern determination of the facts within the ambit of the law—even in a tax case.

> "The retention of an economic interest in oil property (or sand and gravel on a farm) is not necessarily dispositive in every case where the question arises as to whether the proceeds from a conveyance of rights therein shall be treated as capital gain or as ordinary income for tax purposes. Cf. **United States v. White,** 10 Cir., 311 F (2d) 399. It is the substance and effect of the entire transaction which must be examined . . ." (Interpolations ours.)

Wiseman v. Barby, 380 F (2d) 121, 122 (C. A. 10, 1967) (A case wherein facts were stipulated.)

Congress also intended sand and gravel when sold or exchanged to be treated as a capital asset under 26 U.S.C.A. Section 1221, when not sold by one engaged in the sale of such materials in the ordinary course of business.

> Cf. **Gowans v. Commissioner,** 246 F (2d) 448 (C. A. 9, 1957)
>
> **Linehan v. Commissioner,** 297 F (2d) 276 (C. A. 1, 1961)
>
> **Crowell Land & Mineral Corp. v. Commissioner,** 242 F (2d) 864 (C. A. 5, 1957)
>
> **Barker v. Commissioner,** 250 F (2d) 195 (C. A. 2, 1957)
>
> **Remer v. Commissioner,** 260 F (2d) 337 (C. A. 8, 1958)
>
> **United States v. White,** 311 F (2d) 399, (C. A. 10, 1962)

Respondent also errs, as did the Tax Court, in attempting to equate this case with the royalty, lease and license line of cases best illustrated by **Wood v. United States,** 377 F (2d) 300 (C. A. 5, 1967), certiorari denied December 5, 1967, (36 Law Week 3227) (R. Br. pp. 17, 18, 20, 22; Pet. Br. pp. 32-37).

The Fifth Circuit in **Wood** did not overrule but merely distinguished the above cited cases from the Ninth, First, Fifth, Second, Eighth and Tenth Circuits which are similar, in principle, to the cases at bar.

377 F (2d) at 307-312

Respondent and the Tax Court overlooked the facts indicating clearly that the parties to the contract of purchase, Exhibit 6F (R. 84-87) determined the quantity of material sold **with reasonable accuracy** by boring tests prior to delivery of the contract. (R. 42) See discussion of **Gowans v. Commissioner,** 246 F (2d) 448 (C. A. 9, 1957) in **Wood v. United States,** 377 F (2d) 300 at 310.

The contract contained no escape clause for either seller or purchaser. There was no reservation of title in the sellers. Title to all the commercially valuable sand and gravel on the described acreage and constructive possession went to the purchaser on delivery of the contract. (Exhibit 6F) Curtis then performed the contract, a typical capital asset sale.[1]

Curtis, under the contract, had the lawful right to mine the sand and gravel on the described land to exhaustion to fulfill his subcontract at the government

(1) See Uniform Sales Act provisions set forth in Appendix, p. A-1 of this Reply Brief.

damsite. This was the dominant purpose of the contract which, we submit, could have been enforced specifically by either petitioners or by Curtis had it been breached.

> See 4 **Pomeroy, Equity Jurisprudence**, (5th ed.), Sections 1400-1403, pp. 1032-1040.

The contract, Exhibit 6F, was not a vague, unenforceable open-end lease or royalty agreement like that in the **Wood** line of cases, as respondent contends throughout its Brief. Mutuality of obligation gave rise to mutuality of remedy and either party could have enforced performance of the contract, Exhibit 6F.

REPLY TO ARGUMENT

Respondent's Brief, p. 8, states:

> "The construction company was not obligated to mine or pay for any particular amount of materials. The Tax Court was clearly correct in ruling that the payments were depletable ordinary income to the taxpayers, not capital gain as they contend."

Curtis was obligated to remove and pay for all the sand and gravel necessary to perform his subcontract at the Snake River damsite.[2] (R. 84-87; 40-48) Exhibit 6F was a typical contract of sale, not a lease, license or royalty agreement.

> **Linehan v. Commissioner**, 297 F (2d) 276 (C. A. 1, 1961)

(2) Had petitioners not sold their sand and gravel to Curtis, the Government had the right to condemn their land under power of eminent domain.

Respondent argues that Curtis, in effect, had a mere option to take or not to take sand and gravel, inferring that Exhibit 6F was not an enforceable contract of sale and purchase. Only speculation and fictional thinking can offset the expressed intention of the parties to Exhibit 6F which, after all, was fully performed. The taxable event was the sale of the capital assets consistent with 26 U.S.C.A. Section 1221.

Performance of the contract is the best evidence of the intention of the parties and both knew the res of the contract was the amount of materials needed by Curtis to fulfill his subcontract. The price was carefully specified to be paid after each monthly removal indicating clearly no reservation of any "economic interest" in the blocked out sand and gravel described in the contract (R. 42).

> "It is evident that the taxpayer had no 'economic interest' in the material taken from his property after its severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters."
>
> **Remer v. Commissioner**, 260 F (2d) 337 (C. A. 8, 1958)

See also, **Turner v. United States,** 226 F. Supp. 970 (D., Me., S.D., 1964).

Therefore, there could be no depletion allowance to petitioners because they parted with all interest in the blocked out sand and gravel and reserved no economic interest in it.

> See **Barker v. Commissioner**, 250 F (2d) 195 (C. A. 2, 1957)

The depletion allowance relates only to gradual exhaustion of a capital investment in the mineral or hard material deposits and "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." **Commissioner v. Southwest Expl. Co.,** 350 U. S. 308, 312. (R. Br. p. 12) Petitioners did not seek gradual exhaustion of the sand and gravel sold to Curtis. The purchase price paid by Curtis was not production income, rent or royalties. There was a conversion of capital assets into purchase price and petitioners did not look **solely** to the extraction for their return of capital.

Bankers Coal Co., v. Burnet, 287 U. S. 308, decided before **Linehan v. Commissioner** and **Gowans v. Commissioner,** was a typical royalty case, and is not in conflict with **Linehan, Gowans, Remer, Turner** and other cases relied upon by petitioners involving conversion of capital assets. (R. Br. 17-19)

The assumption of respondent that there may have remained on the described lands some "unmined sand and gravel" after the contract, Exhibit 6F, was terminated following performance, is a non sequitur. In absence of proof in the record, it cannot be assumed any commercially valuable materials remained. Curtis removed and paid for all he contracted to take for performance of his government subcontract, the Stipulation admits. (R. 40-48)

Petitioners were not collecting rents or royalties as the respondent and the Tax Court have determined.

Respondent persists in arguing (R. Br. 9, 10) Curtis was not obligated to remove or pay for any particular quantity of materials and was obligated to pay only for that he desired to remove. This is shallow interpretation of the contract, Exhibit 6F. It was carefully entered into and intended to be performed by both parties as a formal contract of sale and purchase, not a mere option or license. There was an obligation to perform by removal of the sand and gravel necessary to perform the Curtis government subcontract. (R. 40-48; R. 84-87)

> Cf. **Ogden** v. **Saunders**, 12 Wheat (U. S.) 213, 6 L. Ed. 606

We accept the principles derived from the Supreme Court cases referred to pp. 10-17, Respondent's Brief. But, the facts in this case bring petitioners' transaction with Curtis within the line of cases above set forth, p. 2 of this Reply Brief. Simply stated, petitioners made an absolute sale of sand and gravel and retained no economic interest in the sand and gravel removed and paid for by Curtis.

Petitioners looked to Curtis for payment, not to mere extraction of the materials nor to a sharing in the resale price or profits received by Curtis.

> **Remer** v. **Commissioner**, 260 F (2d) 337 (C. A. 8, 1958)

As we indicated in Petitioners' Opening Brief, pp. 32-36, all of the five cases in which certiorari was denied December 5, 1967, referred to pp. 16, 17, Respondent's Brief, are lease or royalty cases involving parties engaged in the sand and gravel or hard minerals business for their ordinary income. This, we believe, is suf-

ficient to enable this Court to distinguish those cases from the sales case at bar.

Wood v. United States, 377 F (2d) 300, particularly indicates that the lease and royalty cases in their very nature involve reservation of "economic interest" in the lessor or licensor owner in the materials involved.

In our case, there was neither reservation nor did economic interest revert, as contended by respondent.

Wood, quotes **Burnet v. Harmel,** 287 U. S. 103, at 106:

> "The provisions . . . for taxing capital gains at a lower rate . . . were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."

The Court in **Wood,** 377 F (2d) 300, at 305, then notes significantly that

> "taxation of the receipts **of the lessor** as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act," (Emphasis ours)

again quoting **Burnet v. Harmel.**

Wood then pointed out that in "typical" lease cases it is presumed that "economic interest" is reserved unto the lessor. 377 F (2d) at 305.

As stated in **Rabiner v. Bacon,** 373 F (2d) 537, (C. A. 8, 1967), a case referred to in **Wood,** 377 F (2d) 300, at p. 307, it is difficult "to draw a distinction between a transaction constituting a sale of minerals and one which retains an economic interest in the minerals."

373 F (2d) at 539. The Eighth Circuit Court then went on to point out that a "Lease Contract" was involved in **Rabiner** requiring payment of "rent" and retention of economic interest must be presumed. **Rabiner** distinguished **Remer**, 260 F (2d) 337 (C. A. 8, 1958) as involving "an absolute sale under warrant of title" with no retention of "interest in the property sold." This would justify, we submit, the sale classification sought by petitioners in these cases.

In principle, the "sale and purchase" contract case at bar is more like **Linehan v. Commissioner**, 297 F (2d) 276, (C. A. 1, 1961), **Barker v. Commissioner**, 250 F (2d) 195 (C. A. 2, 1957) and **Gowans v. Commissioner**, 246 F (2d) 448 (C. A. 9, 1957); also **Crowell Land & Mineral Corp. v. Commissioner**, 242 F (2d) 864 rather than **Albritton v. Commissioner**, 248 F (2d) 49 (C. A. 5, 1957) and other cases relied upon in **Wood v. United States**, 377 F (2d) 300, the leading case on royalties.

In **Barker**, Judge Medina emphasized that when title passes to the purchaser there can remain no basis for depletion allowance for lack of economic interest in the seller.

In **Linehan** the contracting parties clearly spelled out a sale of minerals in place rather accurately blocked out, estimated and described and paid for at a fixed rate per cubic yard. The Court said:

> "Turning then to the true substance of the transactions . . . it is evident that the taxpayer had no 'economic interest' in the material taken from his property after its severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters."

In **Crowell,** which, with **Gowans,** was relied upon in **Barker** by Judge Medina, there was a "contract of sale," with fixed per unit prices for the materials removed and paid for. Strong emphasis was placed on the wording of the contract as an unambiguous contract of sale and purchase.

It is important that although **Crowell** is a Fifth Circuit case, it was not overruled in **Wood v. United States,** 377 F (2d) 300, 310-311, but was distinguished and found to be a "sale" not a "lease" or "royalty" situation.

Finally, analyzing the Ninth Circuit case, **Gowans v. Commissioner,** 246 F (2d) 448, the Fifth Circuit in **Wood** again justified the allowance of capital gains treatment of payments made under a contract of sale of sand. 377 F (2d) at 310.

In **Gowans** the form of the contract was that of a sale.

The Court, in **Wood,** 377 F (2d) at 310 said concerning **Gowans:**

> " . . . the buyer was obligated to remove all of the sand and that the quantity of the sand had been determined 'with great accuracy' prior to execution of the agreement."

Just so here, after Curtis, the purchaser, established the quantity needed by borings, the petitioners sold all the commercially valuable sand and gravel on the described lands of petitioners to Curtis under Exhibit 6F. It was removed and paid for in performance of the contract. (R. 42-43)

This solution is also consistent with the rule in the

Tax Court as indicated in **Robert M. Dann,** 1958, 30 T. C. 499, where it was held that a requirement that all sand and gravel be removed is indicative of a sale.[3]

CONCLUSION

When the contract, Exhibit 6F, was delivered, property interests in all of the sand and gravel passed to Curtis. No economic interest remained in petitioners after its removal which could preclude the benefits of capital gain tax treatment under U.S.C.A. Section 1221.

A contract of sale should not be converted into a royalty agreement or license or option agreement by mere magical reasoning, based on fiction.

It was grossly inaccurate for respondent to say (R. Br. 23):

> "So, here, Curtis had no affirmative duty to mine at all, and could terminate their operations at any time without any liability except to pay for the minerals already mined."

Courts must resist destruction of a contract as unenforceable for lack of certainty and endeavor to discover the true intent and then attempt to carry it out.

> **Olson v. Balch,** 63 Wn. (2d) 938, 389 P. (2d) 900 (1964)
>
> **Janzen v. Phillips,** 73 Wn. (2d) 172, ... P (2d) ..... (1968)

Contract law would imply a duty to perform, assuming Exhibit 6F is deemed ambiguous and not sufficiently expressed in the words of the instrument.

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(3) Dann's case was reversed in Linehan v. Commissioner, 297 F (2d) 276 but not on this point.

Cf. **Ogden v. Saunders,** 12 Wheat (U. S.) 213, 6 L. Ed. 606

The Tax Court, we believe, should be reversed as a matter of law and **public policy** as well. Otherwise, it would appear, contrary to Congressional intent, sand and gravel, or other materials in place upon lands, can never be sold as capital assets upon a capital gain tax basis as intended by 26 U.S.C.A. Section 1221.

Respectfully submitted,

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APPENDIX TO PERTINENT WASHINGTON UNIFORM SALES ACT PROVISIONS

R.C.W. 63.04.070 **"Undivided shares.** (1) There may be a contract to sell or a sale of an undivided share of goods. If the parties intend to effect a present sale, the buyer, by force of the agreement, becomes an owner in common with the owner or owners of the remaining shares.

"(2) In the case of fungible goods, there may be a sale of an undivided share of a specific mass, though the seller purports to sell and the buyer to buy a definite number, weight or measure of the goods in the mass, and though the number, weight or measure of the goods in the mass is undetermined. By such a sale the buyer becomes owner in common of such a share of the mass as the number, weight or measure bought bears to the number, weight or measure of the mass. If the mass contains less than the number, weight or measure bought, the buyer becomes the owner of the whole mass, and the seller is bound to make good the deficiency from similar goods unless a contrary intent appears. [1925 ex.s. c 142 §6; RRS §5836-6.]"

R.C.W. 63.04.190 **"Property in specific goods passes when parties so intend.** (1) Where there is a contract to sell specific or ascertained goods, the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred.

"(2) For the purpose of ascertaining the intention of the parties, regard shall be had to the terms of the contract, the conduct of the parties, usages of trade and the circumstances of the case. [1925 ex.s. c 142 §18; RRS §5836-18.]"

R.C.W. 63.04.200 **"Rules for ascertaining intention.** Unless a different intention appears, the following are rules for ascertaining the intention of the

parties as to the time at which the property in the goods is to pass to the buyer:

"**Rule 1.** Where there is an unconditional contract to sell specific goods, in a deliverable state, the property in the goods passes to the buyer when the contract is made, and it is immaterial whether the time of payment, or the time of delivery, or both, be postponed. . . ."

R.C.W. 63.04.230 **"Risk of loss.** Unless otherwise agreed, the goods remain at the seller's risk until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer the goods are at the buyer's risk whether delivery has been made or not, except that:

"(a) Where delivery of the goods has been made to the buyer, or to a bailee for the buyer, in pursuance of the contract and the property in the goods has been retained by the seller merely to secure performance by the buyer of his obligations under the contract, the goods are at the buyer's risk from the time of such delivery.

"(b) Where delivery has been delayed through the fault of either buyer or seller the goods are at the risk of the party in fault as regards any loss which might not have occurred but for such fault. [1925 ex.s. c 142 §22; RRS §5836-22.]"

APPENDIX OF JOINT EXHIBITS REFERRED TO IN THIS BRIEF

CERTIFICATE OF COUNSEL

Cameron Sherwood, one of attorneys for Petitioners, states:

I certify that, in connection with the preparation of this Brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing Brief is in full compliance with these rules.

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